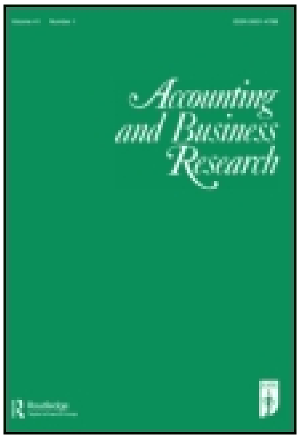

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Discussion of 'Have changes in pension accounting changed pension provision? A review of the evidence'

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Discussion of 'Have changes in pension accounting changed pension provision? A review of the evidence'

Paul Rangecroft*

Kiosse and Peasnell have provided us with a really good paper covering evidence on pension accounting and pension provision across a range of countries. As a practitioner I found it very useful.

The first point made was that the pension obligations are hard to measure, and undoubtedly they are. We talk a lot about reasonable estimates, and there can be very long discussions on what 'reasonable' is. I think our present position, at least from a practitioner's viewpoint, is that what we have to disclose doesn't really hit the core issues relating to pensions. The core way that you have to manage a pension plan and the way it impacts your business is a risk decision more than it is necessarily an accounting standard decision. The significant message would be that you can and should measure these things and come up with reasonable estimates but at the same time that there is much that we can do to communicate what drives the risk behind these plans and how it can impact your business.

The second point in the paper is that the reduction in DB coverage has been driven by a desire to limit contributions. Most companies that I have worked with that have experienced the process of moving from a defined benefit to a defined contribution scheme have used a detailed design process with considerable thought given to many different drivers and competing goals, only one of which is cost. Over the past 10 to 15 years the value of retirement benefits has been reduced, in general and in aggregate. It is my view, and this is brought out in the paper very well, that it is far too simplistic simply to say you move to defined contribution to save money. That is not the case in most of the designs I have seen – whether or not the end result is also that there is money saved. It can be saved in many other ways by staying in defined benefit structures.

Third, we look at US post-retirement welfare benefits. While it is true that there is less contamination of the post-retirement welfare accounting rules because there is no funding requirement, there is also no vesting requirement at this point. So it could be viewed as a microcosm of what pensions might look like if we had not regulated in the way that we have. The complement to that is when FAS 106 came in and companies had to look at this cost, the standard applied only to publicly traded companies. So you look at the government sector, for example, which did not have to report anything other than pay-as-you-go accounting up until a couple of years ago. And yet many government entities were doing projects on their own in order to try and come up with a number for the true long-term liability of these plans. So I think companies would have arrived at the same outcome in any event. What accounting did was highlight the cost a few years before other organisations, not subject to the same accounting rules.

Furthermore, within the US you have to bear in mind the development of Medicare including drug coverage, changes in other retirement benefits and medical inflation (which has continued to soar). These are examples of many aspects that drove post-retirement welfare design differently compared with matters driving pensions. There are many factors to take into account that stop this being a perfect 'microcosm'.

The last point made here, which is probably the point with which I agree the most, is that accounting standards have driven asset allocation. The link on which research has not formed a clear view is: does asset allocation drive pension design and pension provision? I think that is something that needs a little bit more work. I can see reasons why it would. I can see a lot of good reasons why it should not. However, I think it is one that probably requires a little bit more work before we make that leap. And without that connection being made we cannot link accounting rules to plan design.

I thought I would introduce a couple more data points to add to the wealth of research in the paper already. Our consulting practice at Hewitt, ran a survey this year on global pension risk facing multinational companies. We had responses from

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171 companies across 12 countries. The first question we asked was: 'When you are making decisions around pension risk, what are you looking at? What, to you, is risk?' and we saw that balance sheet volatility and profit and loss volatility made up more than half of what is being monitored for risk by companies (see Figure 1). Clearly, accounting rules are critical in how these plans are viewed.

Cash is still in there – a sizeable portion – and 10% of companies said they had a long-term view and were not caught up in these short-term measures. I wish that percentage would grow, but unfortunately it has actually shrunk since our last survey.

The other question that I would probably draw out here is: when we talk about accounting-based interest rate arbitrage, as mentioned in the paper by Kiosse and Peasnell – how does that play out? Because thinking from a pure US perspective, exactly the same thing happens in the cash rules as happens in the profit and loss rules – at a very high level of course. From that perspective, it is not necessarily just accounting-based.

The second question I have taken from the survey is: 'What are you doing because there is pension risk?' There are essentially two major ways you can react to pension risk: (1) you can change your pension provision, which is the entire point of our talk today; or (2) you can actually change the way that you finance or manage your plan to address the risk directly, which is moving into changing your investments and other aspects that Kiosse and Peasnell identify. Our findings are show in Figure 2.

The percentage of respondents who said they had carried out each type of action is in the solid section of the bar. The percentage contemplating doing it in the next 12 months is in the shaded section of the bar. Take the case of 'Close the plan to new hires'. This is easy to do and does not cause a lot of disturbance with current workers. As to the question of whether it manages risk a lot, I think most of us would say it does not because it does not attack the existing risk and liability in the plan. It just inhibits growth a little. Nevertheless more and more companies are doing it. Freezing a plan is a much bigger step, much harder to implement, and far fewer companies are contemplating, or have taken that bigger step.

When we consider some of the focus on managing risk, and you get into changing your cash strategy, looking at integrated financing policies, it becomes more complex – certainly for HR departments to manage and even for many finance departments to manage in-house. Consequently, while there is a lot of interest – and we can see that from the bars being just as big as the plan design change bars – less companies have moved in that direction. I think that is an area where increased disclosure, increased focus on risk measurement and frankly just an increased push from within the company to take a more aggressive stance on asset allocation, derivatives, alternative assets, proactive cash management strategies, will get us to a better place in managing pensions as a whole, which will therefore take the onus off of pension provision being the lever that everybody wants to move.

Continuing that theme – and I think this point is drawn out very well in the last few pages of Kiosse and Peasnell – current statutory disclosures do not give the reader enough to adequately assess the risk that the company is carrying (see Figure 3).

There is no requirement to disclose many of the steps that companies take to mitigate risk, to reduce the risk that is inherent in the pension plan, such as adding derivatives, adding downside equity protection through swaps and so forth. When you look at some of those actions, it is clear that companies that are making those changes, companies that are doing things to better their position, need to make additional disclosures. It leaves open a huge hole when you look at the percentages here. Even in the UK, which has been most aggressive about taking some of these actions, you are still not even reaching more than a third of companies that provide additional disclosures, which means you have two-thirds of companies sitting out there with large pension plans that don't tell you anything more than the statutory rules, and therefore don't give analysts and observers enough to decide whether you should be buying their stock or not, or the risk that is inherent in buying it. It's an area I think that needs to be addressed aggressively as we move forward. So if accounting rules are one of the influencers of pension provision, the more information we put out there, the better the statutory disclosures, the better that influence becomes and the better decisions are made because of it. And I think that is the key extrapolation from what we have seen here.

There is an excellent brochure available if you get a chance to read it, which is *Corporate Disclosure and the Cost of Capital*.[1] There is a note in there that the communication that works best in getting information across to fund managers and analysts is in presentations and one-on-one meetings. It's interesting to read that, in the UK, making disclosures in accounts is by far the most prevalent method for additional pension disclosure. The US and Canada seem to have got the message on effective communication, and I don't think they've seen the booklet yet!

[1] Armitage, S. and Marston, C. (2007). *Corporate disclosure and the cost of capital: the views of finance directors*. Briefing, The Centre for Business Performance, The Institute of Chartered Accountants in England and Wales. http://www.icaew.com/index.cfm/route/148607/icaew_ga/pdf.

Figure 1
Main factors influencing a sponsor's decisions regarding 'pension risk'

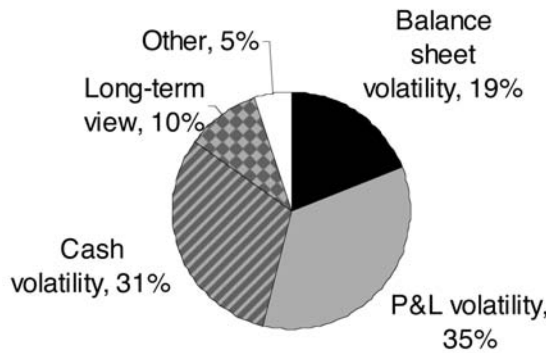


Figure 2
Actions taken to control 'pension risk' in pension plans

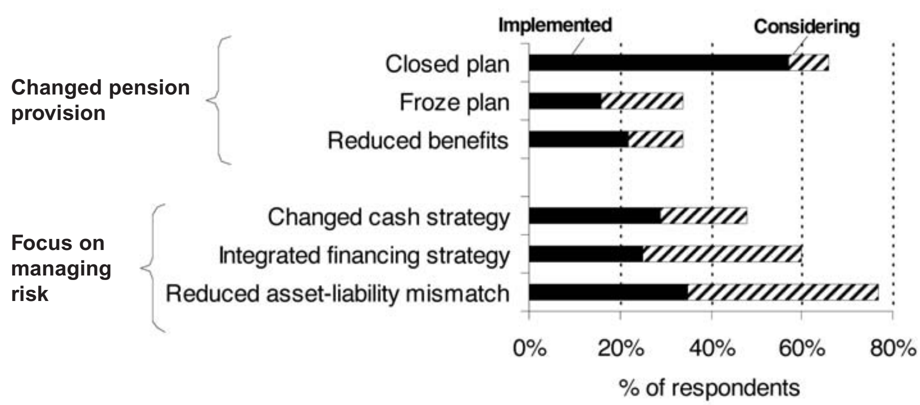
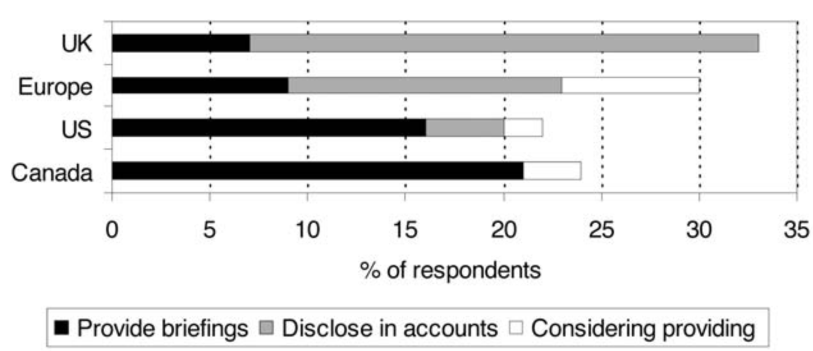


Figure 3
Companies providing additional information beyond statutory disclosures to elaborate on pension risk and risk mitigation approaches



The overall message is that there are many reasons for redesigning plans. Accounting, I believe, is one of them, but it is only one. Many of these are worth additional consideration. The regulatory case is a great example. In the UK, there was no coincidence that the rules around job-hopping risk, inflation risk and default risk, occurred around the same time that defined benefit was becoming less attractive. It was plain to see. This implied causality is indicated in Kiosse and Peasnell's paper.

However, in the US, job-hopping risk was addressed through vesting in the 1970s. Inflation risk has never been addressed in the US. Default risk was addressed in the 1970s as well, and at that time pension plans in the US were still increasing in number. This kind of analysis indicates that there are many other things that will drive decisions on design beyond merely the accounting aspect.

The US is moving with the continued trend towards mark-to-market and increasing short-term volatility. Canada has already adopted IFRS, but that form of accounting is not yet implemented. The question this poses for me is more about asking, given that there is some influence on pension provision here: will the accounting rules promulgated in the future influence companies to make short-term, inappropriate, sub-optimal decisions or will they influence companies in a way that improves overall pension management? That, for me, is probably the question that will unfold in the next few years. It is an absolutely critical one.